Development Credit Authority

Operations Manual

United States
Agency for
International
Development

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DCA Operations Manual

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APPENDICES

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Background

PURPOSE OF OPERATIONS MANUAL

The *DCA Operations Manual* describes the overall process to develop and monitor a Development Credit Authority (DCA) project. The primary audiences of this Manual are USAID overseas offices and technical/regional bureaus interested in further understanding how DCA projects are started, developed, and monitored. Their roles and responsibilities are critical to successfully implement a DCA project. Equally as important, the USAID Office of Development Credit (ODC) will provide the centralized role of coordination and monitoring of the DCA portfolio. Other USAID entities involved in DCA projects, such as the Office of General Counsel and the Office of Financial Management, should also adhere to the operating procedures presented in this Manual.

DCA Guidelines
♦ADS No. 249♦
♦Operations Manual♦
♦Credit Risk Assessment Handbook♦

It should be noted upfront that this *DCA Operations Manual* is not a stand-alone document. The Automated Directive System (ADS) comprises USAID's official, written guidance on policies, operating procedures, and delegations of authority for conducting USAID business. *ADS No. 249* (http://www.usaid.gov/pubs/ads/200/249.doc) provides specific guidelines to the policies and procedures of DCA. Based on the policies outlined in the ADS No. 249, two manuals have been produced to further detail internal guidelines for DCA projects. *The DCA Operations Manual* provides Missions, the ODC and other parties with a set of standard operating procedures for DCA, while the *USAID Development Credit Risk Assessment Handbook* details how to assess DCA credit risk.

DCA OVERVIEW

Originally authorized by Congress in FY1998, the Development Credit Authority (DCA) provides overseas USAID Missions[1] with a tool by which they may encourage the use of credit and expand financial services in underserved markets. This Authority, supported by the USAID Office of Development Credit, allows USAID Missions to partner with local lending institutions in making resources available for investments that support development objectives. Through DCA, Missions insure a portion of the risk with the lending institutions. As a result, a small amount of USAID development assistance funding enables the local banking sector and other sources of private capital to take on projects that otherwise would not be funded.

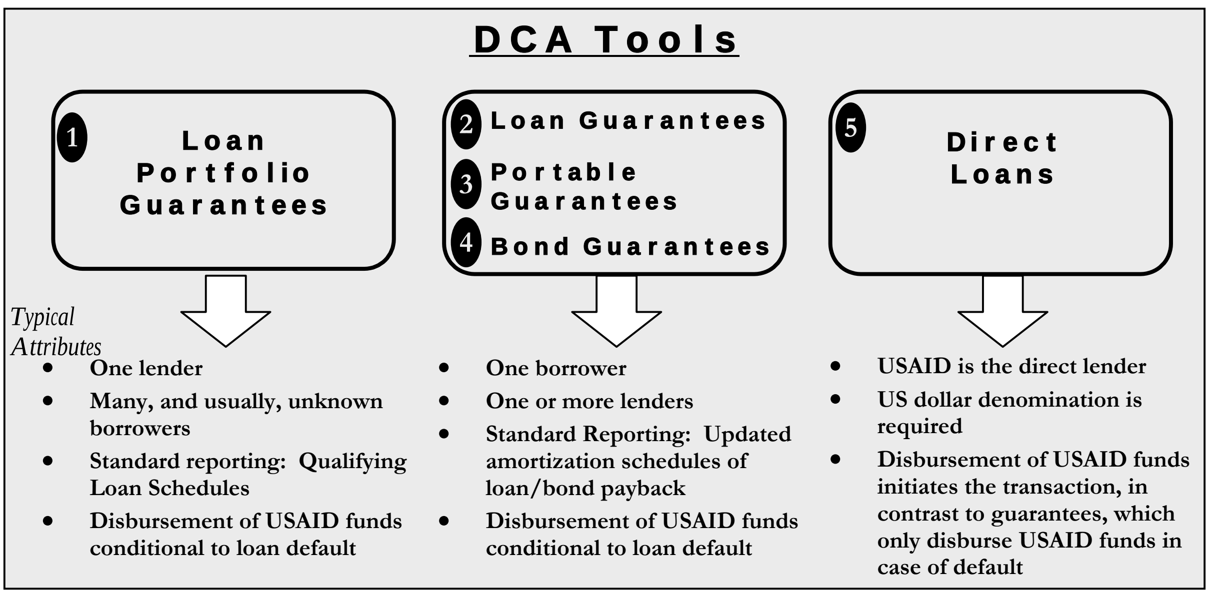
1 Throughout this manual, a "Mission" is identified as the USAID operating unit that can originate and develop a DCA project. Regional and technical USAID bureaus can also develop DCA projects; Missions are solely identified to simplify this document. Also, the majority of DCA projects through FY2001 have originated from overseas Missions.

The goals of DCA are two-fold:

- Mobilize private capital to finance development initiatives abroad; and
- Demonstrate the economic viability of such investments to the local banking sector and to other sources of private capital.

DCA PRODUCTS

The use of credit provides USAID with a powerful tool for achieving its development goals. Private sector resources can be mobilized in many ways through a number of appropriate financial instruments available under DCA. By selecting the most appropriate credit instrument for a specific project, USAID assures efficient and effective use of assistance resources while providing local participants a stake in their own success. This flexibility of credit, the partnerships, and the interaction with local market participants are the cornerstones of DCA's effectiveness. The five credit tools available to Missions through DCA are divided into three categories, which will be explained subsequently.



Loan Portfolio Guarantee

A Loan Portfolio Guarantee provides financial institutions with partial coverage on a portfolio of loans that they provide to their customers. In the case of the Loan Portfolio Guarantee, USAID agrees to share in the risk of a broadly defined category of bank loans with a view toward inducing local banks to extend credit toward an underserved sector. If these customers are lending institutions, the DCA guarantee is referred to as a "wholesale" guarantee.

Loan Guarantee

The typical Loan Guarantee, also referred to as a project-specific guarantee, allows USAID to use DCA for specific credit enhancement purposes in cases where the borrower, lender, and uses of loan proceeds are known.

Portable Guarantee

Slightly different than the Loan Guarantee, the Portable Guarantee provides the borrower with a letter of guarantee commitment through which the borrower may seek the most advantageous terms from the local financial market. Portable Guarantees are appropriate for specific credit enhancement purposes and the purpose and borrower are known, but the lender is not yet known. In these cases, a minimum credit rating (e.g., from rating agencies such as Standard & Poor's and Moody's) is established, and the risk calculation and subsidy cost[2] are based on the assumption that the eventual lender will have a rating equal to or above this minimum rating.

Bond Guarantee

Bond guarantees support the issuance of bonds by financial institutions, private sector corporations, or sub-national entities. The funds generated from the bond issuance can, for example, assist in raising local funds to initiate municipal infrastructure or utility projects, which require substantial upfront capital investments. The bond guarantee is typically an option for DCA credit assistance if the capital and financial markets are fairly well advanced in a particular country to support a bond issuance. However, the DCA guarantee can also be used to encourage the development of bond issuances in less sophisticated markets.

Direct Loan

Direct loans to creditworthy institutions will be used only in cases where private sector financing is not feasible/available. Disbursements should normally be made directly to the borrower (as opposed to contractors or suppliers) to finance the borrower's eligible activities as defined in the loan agreement. These loans predominantly support activities in more than one country, for example through a multinational non-government organization. DCA loans are also based in U.S. dollars to reduce foreign exchange risk.

Common Attributes of DCA Products

Several common aspects of the aforementioned DCA credit tools, across the three categories, should be noted as a USAID Mission decides to pursue a DCA project. These attributes are intended to provide guidance and further clarification of how DCA projects are structured. However, USAID Missions should also realize that these attributes are not strict regulations that prohibit alternatives that deviate from these norms. DCA is designed to be flexible to suit the particular needs of a project. USAID Missions must submit all exceptions to the standard DCA terms and conditions for approval by the Chief Financial Officer through the Credit Review Board (CRB)[3] in USAID/Washington.

- **Preference of Local Currency Denomination**: DCA credit instruments can be denominated in either U.S. dollars or local currency, but the typical loan is originated in local currency in order to match the revenues generated by the project to loan repayments.

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2 The subsidy cost is the 'price' the Mission pays for the DCA guarantee. It is useful to think of the subsidy cost as a type of loan loss reserve in the case of default, or as a type of insurance premium that is paid whether or not an event occurs. For a detailed definition of subsidy cost, see Appendix II.

3 The CRB consists of the CFO, as chairperson, a senior officer of each of the four Regional Bureaus, and representatives from the Office of General Counsel and the Bureau for Policy and Program Coordination. The Office of Inspector General shall advise the CRB on past audits and investigations and participate in discussions on new issues.

- **Guarantee Ceiling**: DCA guarantees require true private sector risk-sharing, and therefore, USAID's contingent liability is limited to a maximum of 50 percent of the financial institution's net loss. Guarantee coverage in excess of this ceiling must be approved by the CRB. In order to avoid U.S. Government exposure to extreme currency fluctuations, this Guarantee Ceiling is also expressed in U.S. dollars.

- **Maximum Term**: Unless otherwise approved by the CRB, no DCA guarantee may have a term in excess of 20 years. DCA term lengths should be consistent with normal financial practice, to the extent practicable, taking into account the useful life of the project and the anticipated cost recovery streams.

- **Origination and Utilization Fees**: A one-time origination fee of not less than 0.25 percent of the Guarantee Ceiling should be charged as determined by the authorizing official and justified in the activity analysis. Utilization fees of a minimum 0.25 percent per annum of the guaranteed portion of outstanding principal amount are normally charged on a semiannual basis. DCA fees partially compensate the U.S. Government for its obligation to pay future claim defaults.

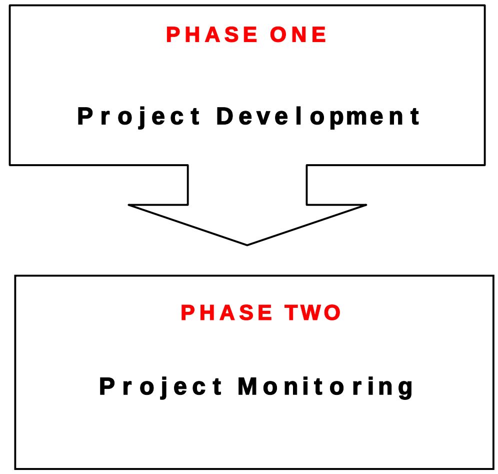
Distinct Attributes of DCA Products

- **Reporting Requirements**: A loan portfolio guarantee will require participating financial institutions to submit quarterly or semiannual reports on the status and utilization of the DCA guarantee. Standard reporting includes a listing of guaranteed loans, coverage dates and outstanding principal balance updates to permit accurate billing and collection of utilization fees. New loans under coverage will also be updated to ensure that 1.) the portfolio of loans complies with the intended purpose of the guarantee and 2.) the total amount of cumulative loans placed under coverage does not exceed the total authorized amount as stipulated in the guarantee agreement.

  In contrast, a DCA loan guarantee, portable guarantee or bond guarantee is based on a single debt instrument, such as a loan or bond. Reporting on this instrument typically involves the creation of an original amortization (i.e. repayment) schedule, which the financial institution will update semiannually or annually to report that the borrower is paying off the debt as anticipated.

- **Utilization Performance Measurement**: Loan portfolio guarantee balances will increase and decrease depending on the placement of new sub-loans under guarantee coverage and the removal of sub-loans from guarantee coverage. In contrast, loan, portable and bond guarantees will typically begin with the full amount of outstanding principal and gradually decline over time as the borrower pays back the loan or bond.

PROCESS OVERVIEW



The overall DCA process is split into two distinct phases: Project Development and Project Monitoring.[4] DCA project development and monitoring are further detailed in the main sections of this *DCA Operations Manual*. The Office of Development Credit has also created a "*10-Step Guide to Preparing a Development Credit Authority (DCA) Project*" which provides an overview of the Project Development section of this *DCA Operations Manual*. For those interested in gaining a simplified, high-level understanding of DCA project development steps, please refer to the *"10-Step Guide"*. For a more detailed and complete description of the development phase, the *DCA Operations Manual* is the most comprehensive resource.

Brief highlights for those interested in the project development and project monitoring phases, and not the details of this process, are as follows:

Project Development

The sponsoring USAID office, typically an overseas 'Mission', works with potential lenders and/or borrowers to structure the DCA credit instrument. The Mission should seek technical advice from relevant offices, including credit and project structure advice and guidance from the Office of Development Credit, as required. Following a series of required analyses, which are summarized in an Action Memorandum, the Mission requests USAID CFO approval of the DCA subsidy transfer. These analyses include:

- *Development Analysis* to ensure the activity meets a USAID strategic objective
- *Economic Viability Analysis* to verify that USAID is the "lender of last resort" and that the DCA credit tool addresses a market imperfection related to local private capital
- *Financial Viability Analysis* to assess the ability of the project to earn sufficient income to cover operating and administrative costs, including debt service payments

In addition to these analyses, the following documents must be included in the Action Memorandum.

- *Financial Monitoring Plan* to address how the Mission and the ODC will monitor the credit activity
- *Fee Justification* to validate how the origination and utilization fees are determined

These analyses and documents provide the necessary data inputs for the ODC to conduct a credit risk assessment to be submitted with the Action Memorandum. At the same time, the Mission, in coordination with the ODC and with support from the USAID Office of General Counsel, should draft legal agreements to specify the obligations of all involved parties. Following CFO approval of

[4] A DCA "project" throughout this Manual refers to a proposed DCA activity in a Mission.

the subsidy, the Mission must submit a Congressional Notification to disclose its intended budget utilization, which includes the funds transfer to the DCA program account. The Mission then requests the funds transfer from USAID/Washington. Once the funds are transferred, the Mission proceeds to finalize and sign legal documents to initiate the DCA project.

Project Monitoring

The primary aspects of monitoring a DCA project are: utilization, risk exposure, timeliness of fee payments and reporting, subsidy reviews, and claim payments. The Office of Development Credit, with field support from the Mission, will coordinate these monitoring responsibilities.[5] Project monitoring concludes with 'close-out' activities at the end of the loan/guarantee term.

Typically, the participating financial institution will be responsible for submitting semiannual or quarterly reports to the Mission and to the Office of Development Credit. If there are errors, discrepancies or possible non-compliance issues in reporting, or if the reports are late, the ODC will contact the Mission to request direct follow-up with the participating financial institution. In this regard, the ODC will take the lead role to ensure that the reports from the participating financial institutions are compliant as stipulated in the DCA guarantee agreements.

Once this review is complete, the ODC will forward these reports to the Office of Financial Management, Loan Management Division (FM/LM) and its 'Financial Agent' contractor for fees, billing and collection.[6] The manner in which fee tracking is coordinated by the ODC is detailed in a later section of this Manual.

Annual reviews of the "subsidy" (loan loss reserve) of the DCA guarantee or loan begin with the ODC collecting audited financial statements of lenders/borrowers. ODC staff will then review and assess the current conditions of the DCA project and determine if the current subsidy requires adjustment based on the estimated risk exposure for the DCA project. Any upward adjustment to the subsidy level will be covered by the permanent indefinite appropriation, which will not affect Mission funds. Downward adjustments involve returning excess subsidy to the U.S. Treasury.

In the event of a claim request from a borrower or lender, the ODC is responsible for the initial evaluation prior to forwarding the request to the Mission for review. The Mission Director then approves the claim payment, and requests from FM/LM, the appropriate funds transfer for claim payment. In exceptional cases, based on claim amounts that represent a significant proportion of the authorized amount guaranteed by USAID, the ODC will consult the CRB for guidance.

ROLES AND RESPONSIBILITIES

The following table summarizes the roles and responsibilities in project development and monitoring for all the key entities involved with DCA.

[5] The ODC is in the process of developing a database system, Credit Management System, to collect, monitor and analyze DCA portfolio data.

[6] Unless otherwise noted, "FM/LM" refers to the Office of Financial Management, Loan Management, and its "Financial Agent" contractor throughout this Operations Manual.

ENTITY	RESPONSIBILITIES
Mission	• Gathers data for proposed DCA activity and conducts development analysis • Coordinates economic viability and financial viability analyses with ODC • Prepares fee justification • Provides inputs for risk assessment • Develops financial monitoring plan in conjunction with ODC • Prepares Congressional Notification • Monitors activities (financial & developmental aspects) • Responds to non-compliant borrowers/lenders as requested by ODC • Approves claim payments and submits request for funds to be disbursed by FM/LM • Prepares Exception Reports in cases of possible default
Office of Development Credit	• Provides activity development support as requested by Mission • Assists and reviews Mission's financial viability and economic viability analyses • Submits monitoring plan template to Mission to include in Action Memorandum • Performs risk assessments and subsidy cost calculation of activities; also calculates annual re-estimates of subsidy costs • Assumes overall responsibility for monitoring and portfolio management for all DCA projects (including monthly and quarterly portfolio status reports) • Reviews and submits claim payments to Mission for approval/payment
Credit Budget Officer (PPC)[7]	• Tracks and monitors DCA program and financing accounts • Coordinates Congressional Notifications with Regional Bureaus • Coordinates DCA appropriation with OMB • Participates in annual President Budget exercise related to credit programs
Office of FM/LM	• Monitors fee billing and collection activities. • Disburses claim payments once approved by Mission Directors • Performs general ledger accounting functions for all credit programs • Prepares financial statements
Financial Agent (as contracted by FM/LM)	• Bills and collects funds on behalf of USAID • Issues Notices of Payment Due and first late notice if fees not received • Prepares weekly reports on delinquent fee payments and late reporting • Prepares monthly "Control Logs" delineating utilization, disbursements, and receipts of credit related activities • Provides ledger accounting data for all credit programs, and feeds this data to USAID Standard General Ledger
Credit Review Board	• Reviews and recommends financial and economic analyses, financial monitoring plans, and subsidy cost estimates for the Chief Financial Officer's approval • Oversees the financial soundness of USAID credit programs • Reviews/recommends to CFO any deviations or unusual credit activities
Chief Financial Officer	• Approves activity-specific financial and economic analyses and financial monitoring plans • Approves the credit subsidy cost • Approves any deviations from DCA standards
Office of General Counsel	• Provides legal assistance for loan and guarantee agreements, work-outs and activity termination • Provide inputs to Regional Legal Advisors as required
Office of Management & Budget	• Compiles annual budget submission and provides budgetary approval • Reviews and approves new credit models • Appropriates subsidy (loan loss reserve) funds to DCA Account

[7] Position to be created in the Bureau of Policy and Program Coordination (PPC).

GUIDING PRINCIPLES

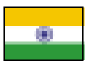
DCA is focused on ten guiding principals:

Principle 1	DCA is not a separate development program, but rather **a financing tool** to be used in addition to or in lieu of grant funding where appropriate.
Principle 2	DCA shall be a **demand-driven** initiative, with USAID Missions and Bureaus having primary responsibility for designing, authorizing and implementing activities that support development objectives.
Principle 3	DCA will be used primarily in USAID presence countries in **support of USAID strategic objectives**. DCA is also an appropriate exit strategy in countries where USAID assistance is being phased out.
Principle 4	DCA shall be restricted to **non-sovereign partners**, which may include sub-national, local authorities, or private sector entities.
Principle 5	DCA requires **independent assessments** of the development impact and the credit risk to ensure impartial and appropriate evaluations. As such, USAID Missions usually lead the development feasibility analysis and the Office of Development Credit performs the credit risk assessment.
Principle 6	DCA requires true **risk-sharing**. For loan guarantee transactions, USAID covers a maximum of 50 percent of a lender's risk, with at least half of the default risk covered by a private sector financial intermediary or the borrower.
Principle 7	DCA intends to address **market imperfections** and shall be used as the "lender of last resort." Assistance shall be made at market rates so as not to subvert existing financial markets.
Principle 8	DCA credit-related instruments shall be used with projects that demonstrate **positive financial rates of return**, i.e. a capacity to service current and future debt obligations, and where the risk of default may be reasonably estimated and managed.
Principle 9	**Currency mismatches** are strongly discouraged. Revenues generated by DCA-supported activities should match the currency of the borrower's debt obligations.
Principle 10	DCA **fee structures** are to be designed to encourage utilization, while taking into consideration local practice and the development rationale of the DCA project.

SAMPLE DCA PROJECTS

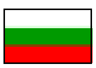
Even if there is the potential to generate income, development projects can often be perceived by local credit markets as risky endeavors. In economies where these types of projects do not occur, market distortions can remain, resulting in inefficient economies and under-represented and disenfranchised segments of society.

From microenterprise financing to renewable energy promotion to mortgage market creation, DCA projects help fill voids left by inefficient or underdeveloped markets. Once the sustainability and profitability of such projects is demonstrated, local institutions are more likely to expand financial services to traditionally under-represented economic sectors and social groups. Often, this sets in motion a long-term process for meeting the on-going credit needs of municipalities and private and non-profit organizations in less developed countries.



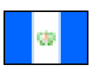
INDIA

In partnership with an urban development fund, USAID/India is using a DCA guarantee to insure a portion of a municipal bond issuance. The capital raised by the bonds is being used to fund water supply and sewage treatment projects near the metropolitan area of Chennai.



BULGARIA

USAID/Bulgaria uses DCA to reduce energy consumption and costs by encouraging municipalities to undertake needed infrastructure improvements and to promote private sector lending for energy efficiency projects. DCA partially guarantees private bank loans to municipalities for energy-efficiency projects.



GUATEMALA

The Mission in Guatemala uses DCA to spur entrepreneurial and infrastructure development activities. With a DCA guarantee, USAID/Guatemala has been able to encourage private investment to help rebuild a region highly affected by a recent civil war.

MEXICO

USAID/Mexico guarantees financial institutions to increase investment opportunities available to micro-, small-, and medium-sized enterprises throughout Mexico. DCA provides rural and urban banks and credit unions with 50% guarantees to expand lending activities to these targeted entrepreneurs.

SOUTH AFRICA

USAID views infrastructure projects as a key component of economic growth. The Mission uses DCA loan guarantees to support investment in water, utilities, and infrastructure projects by Johannesburg's municipal environment and infrastructure authority.

Further Details (ADS 249)[8]

DCA is the legislative authority that permits USAID to issue partial loan guarantees to private lenders to achieve the economic development objectives in the Foreign Assistance Act of 1961. DCA guarantees require true private sector risk-sharing where the USAID share of credit risk does not exceed 50 percent (exceptions to this limit require special approval). DCA permits USAID to offer a mixture of grant and credit assistance in settings where USAID seeks more disciplined and sustainable assistance relationships. DCA also authorizes USAID to make direct loans.

DCA is a low cost, credit enhancement or tool to introduce private lenders and investors to creditworthy but underserved markets. It is based on the assumption that sustainable economic growth will occur when private financial markets in developing countries learn to emulate U.S. financial markets by mobilizing domestic capital and putting it to work.

DCA cannot be used for sovereign borrowing that could be subject to Paris Club[9] rescheduling. In contrast, DCA is intended for use in lieu of more costly grant assistance when a Mission can achieve the same goals, the borrowers are reasonably creditworthy, the projects are financially viable, and market imperfections prevent funding from commercial sources.

Leverage, a key factor that makes DCA useful, results when USAID partial guarantees induce private lenders and investors to finance activities that support the Strategic Objectives (SO's) of the Missions. Leverage also results from Federal budget scoring rules under the Federal Credit Reform Act of 1990 (FCRA), which permits Federal Agencies to issue loans and loan guarantees having a nominal value far in excess of the value of appropriations. As a result, Federal agencies that can achieve some of their goals with credit assistance have an enormous budget advantage over those that cannot.

Under DCA, Missions have the flexibility to fund their activities with 100 percent grants, or they can transfer some of their funds to the DCA Account, and in effect, purchase the right to issue full faith and credit U.S. Government guarantees or loans, having a value far greater than the transferred funds. The actual cost to a Mission, termed the "subsidy cost" (as defined in ADS 249.6), to issue a loan or guarantee is determined by the USAID Chief Financial Officer (CFO) in Washington using risk assessment models approved by the Office of Management and Budget (OMB).[10] This subsidy can be perceived as a loan loss reserve or an insurance premium that estimates the true cost of the credit transaction based on forecasted fees collected and possible loan payment defaults.

Due to true risk-sharing with private sector "partners" on non-sovereign credit instruments, DCA guarantee activities are expected to be financially sound. USAID's private partners, which agree to share the majority of the financial risk, are expected to perform thorough independent risk analyses and provide adequate project management and oversight. This results in effective project oversight, especially in conjunction with Mission and ODC monitoring responsibilities.

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8 "ADS" is the USAID Automated Directives System.

9 The Paris Club is an informal group of official creditors whose role is to find solutions to the payment difficulties experienced by debtor nations. Paris Club creditors agree to reschedule debts due to them. Rescheduling is a means of providing a country with debt relief through a postponement and/or a reduction in debt service obligations.

10 OMB supports the U.S. Executive Branch with budget oversight, as well as coordination of procurement, financial management, and regulatory policies, for the entire federal government.